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DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

RICHARD RUSSELL
P. O. Box 15196
San Diego 15, California

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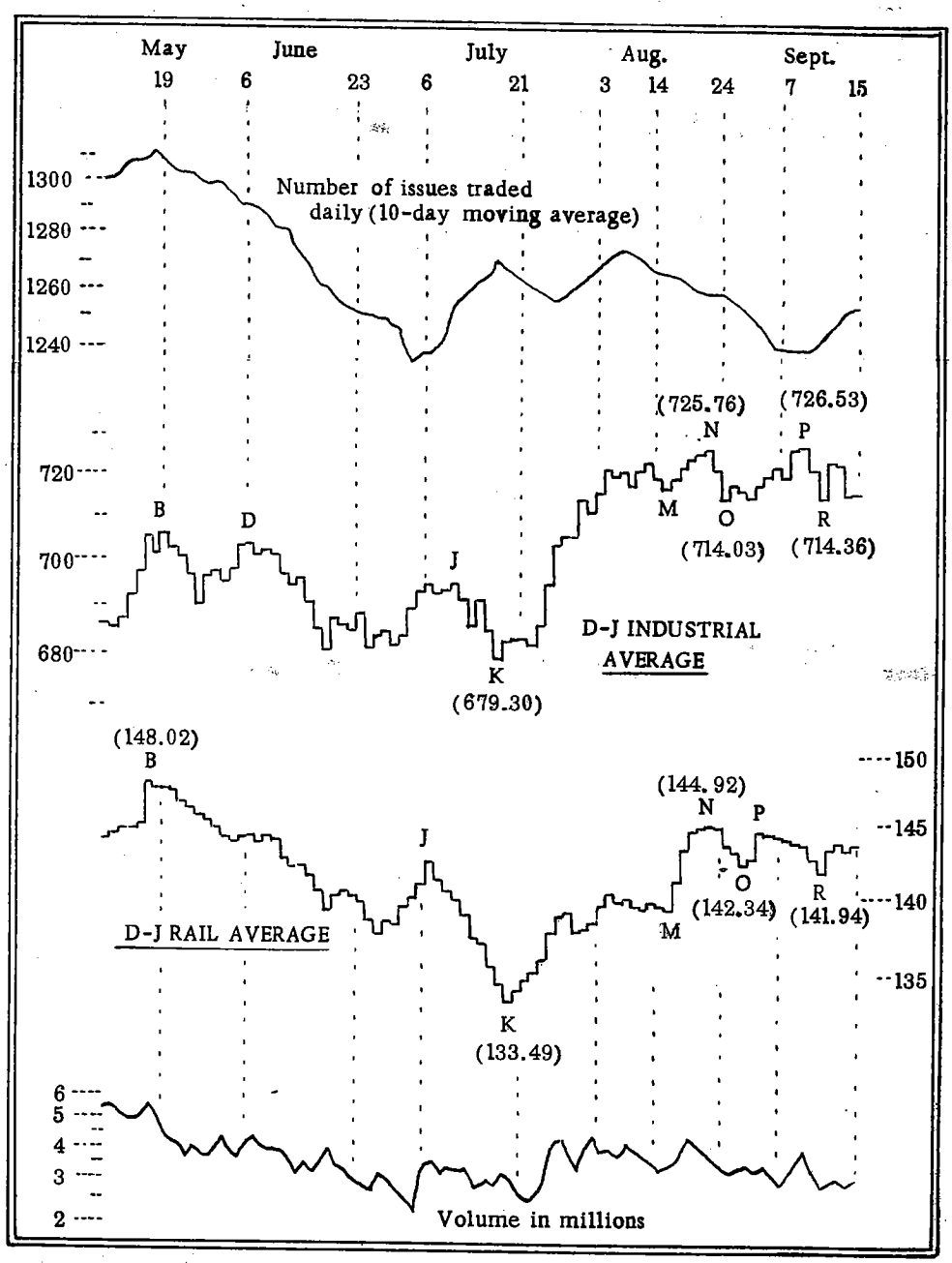
THE MARKET Letter 155 noted that for 24 consecutive days the Industrial Average had been fluctuating within the narrow trading range of 11.73 points, while for 14 trading days Rails had been moving within a range of 2.58 points. Joint penetration (by both Averages) above or below such a narrow trading range (commonly called "a line"), stated Letter 155, usually provides an important forecast as to the future direction of prices.

On September 7 the Industrial Average rose above its trading range to a fractional new all-time high of 726.53 (P on chart.). This penetration was not confirmed by Rails and must therefore be considered meaningless.

On September 11 (R) the Rail Average dipped fractionally under its trading range, thereby penetrating the preceding Rail low at 0 (142.34) by 40¢. On the decline the Industrial Average halted at R (714.36), exactly 33¢ above its preceding low at 0. Because the Industrial Average would not confirm on the downside, the Rail penetration must also be considered meaningless. Under Dow Theory, a penetration by one Average unconfirmed by the other is of absolutely no forecasting value.

On September 14 the two Averages declined again, and for the fourth time in the last 15 trading days Industrials "tested" the 714 area. As of this writing (September 18) the lows of the "line" are holding intact (on both Averages).



CONCLUSION: If both Averages violate their recent lows (Industrials: 0-714.03, Rails: R- 141.94) on increasing volume, the secondary trend will have reversed from bullish to bearish, and trading profits will definitely be in order. Conversely, a joint rise above the recent highs (Industrials: P-726.53, Rails: N-144.92) on increasing volume would be a signal for generally higher prices and a reconfirmation of the upward secondary trend. The primary trend is taken to remain bullish.

ISSUES TRADED Letter 155 included a chart of the advance-decline ratio on the American Exchange, and the

sagging appearance of that ratio testified to the absence of public interest at this time (the stocks on the American Exchange tend to be speculative or "crowd" stocks). Earlier, Letter 149 commented upon the daily number of issues traded as a gauge of public interest, and the Letter concluded with the thesis that the number of issues traded (like volume) rises and falls with general interest in the market. I have included (on page 1) a graph which traces the daily number of issues traded (smoothed out in the form of a 10-day moving average), and we can see that the number of issues traded has been confirming what the American Exchange, volume and the odd-lot statistics have been saying--namely, that public interest has been waning in the market since April and May of this year.

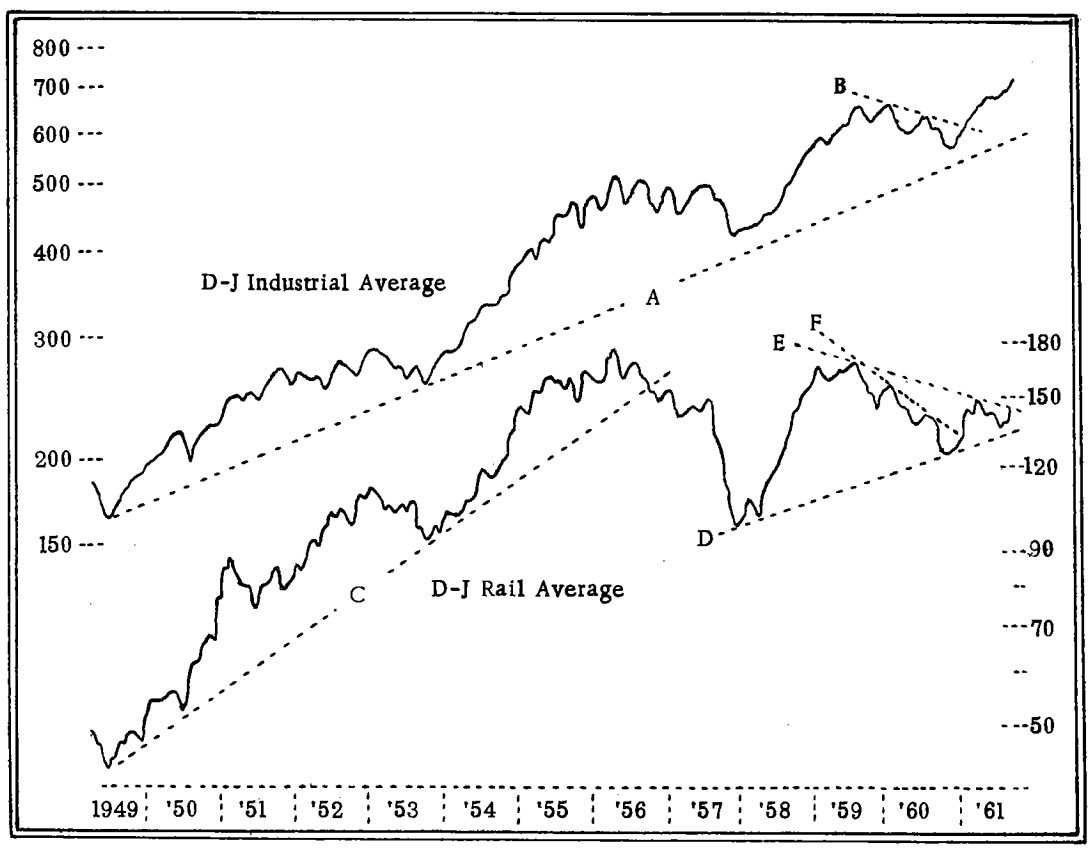
From the record breaking 1311 issues (10-day average) traded on May 18, the number of issues traded contracted to 1237 on July 4 (during the decline). The subsequent Industrial rally to above 720 succeeded in bringing out a maximum of only 1280 issues traded (August 7), following which, the market sank back as the number of issues traded dropped to a low of 1242 (September 7).

These figures underscore the public apathy which accompanied the recent rally (during which the "blue-chip" D-J stocks rose to an all-time high). But since public excitement generally prevails at major primary turning points, the statistics also suggest that there is less basis for calling a major turn now than there was last April and May when the crowd was in the market "with both feet". The possibility of a full secondary correction or consolidation at this time can not be dismissed, however.

TRENDS Periodically (for my own edification and, I hope, for the edification of readers), I try to review the price movements over the longer term. Letter 151 examined the market swings from 1942 to the present from the standpoint of Dow's 50% Principle. The conclusion drawn from that study was that over the last nineteen years every major decline has held above the halfway or 50% level of the preceding major advance. Under the 50% Principle, this action was taken to provide consistently bullish long-term implications.

Although trendlines play absolutely no part in Dow's Theory, it is nevertheless true that stocks (and stock averages) tend to move in a manner approximating straight lines (this is particularly apparent when price movements are charted logarithmically). Why the market phenomenon of the straight-line trend actually occurs has never been satisfactorily explained; it is a principle which (like so many other market principles) has been discovered and born out by experience.

In a rising market, trendlines connecting significant decline points are drawn. In a declining market, trendlines connecting significant tops are drawn. A trend is generally conceded to remain in force as long as the price pattern holds above the ascending trendline (during advances) or below the descending trendline (during declines). The longer a trendline holds in force (without being violated) and the more times it is "tested" (approached but not broken) the more importance is attached to that trendline. A trend is considered to be reversed when the trendline suffers a significant penetration in the opposite direction.



In view of the above, it is interesting to note (see chart) that the major trendline (A) connecting the 1949 and 1953 bottoms on the Industrial Average has remained in force from 1949 to the present. Neither the

1957 nor the 1960 declines succeeded in breaking this great trendline, and until this trendline is violated, many market students will not concede the existence of a major bearish force.

A bearish descending trendline (B) drawn through the two 1960 peaks was reversed in January, 1961, when the Industrial Average bettered the 620 level. At present, the major bullish Industrial trendline (A) stands at about 570.

The major ascending trendline (C) on the Rail Average was violated in 1956. (Perhaps significantly, the advance-decline ratio and many stock groups recorded their post-war peaks at that time; i.e. coppers, oils, aluminums). Following the 1957 Rail collapse, a new ascending trendline (D) began for Rails (connecting the 1957 and 1960 bottoms). The 1959-60 decline gave rise to the bearish Rail trendline marked F, but this trendline was penetrated upwards in January, 1961, when the Rail Average bettered the 135 level. A second (shallower) descending Rail trendline (E) will be bettered if Rails can hurdle the 147-50 area.

It is notable that the price swings on the Rail Average have been diminishing progressively since 1956. Such gradually decreasing arcs often imply a forthcoming move of considerable force. For this reason, a Rail move above the E trendline (above 147-50) or below the D trendline (below 130-32) would suggest a strong further move in the direction of the penetration. The odds heavily favor the rest of the market's following in the direction that the Rail Average takes.

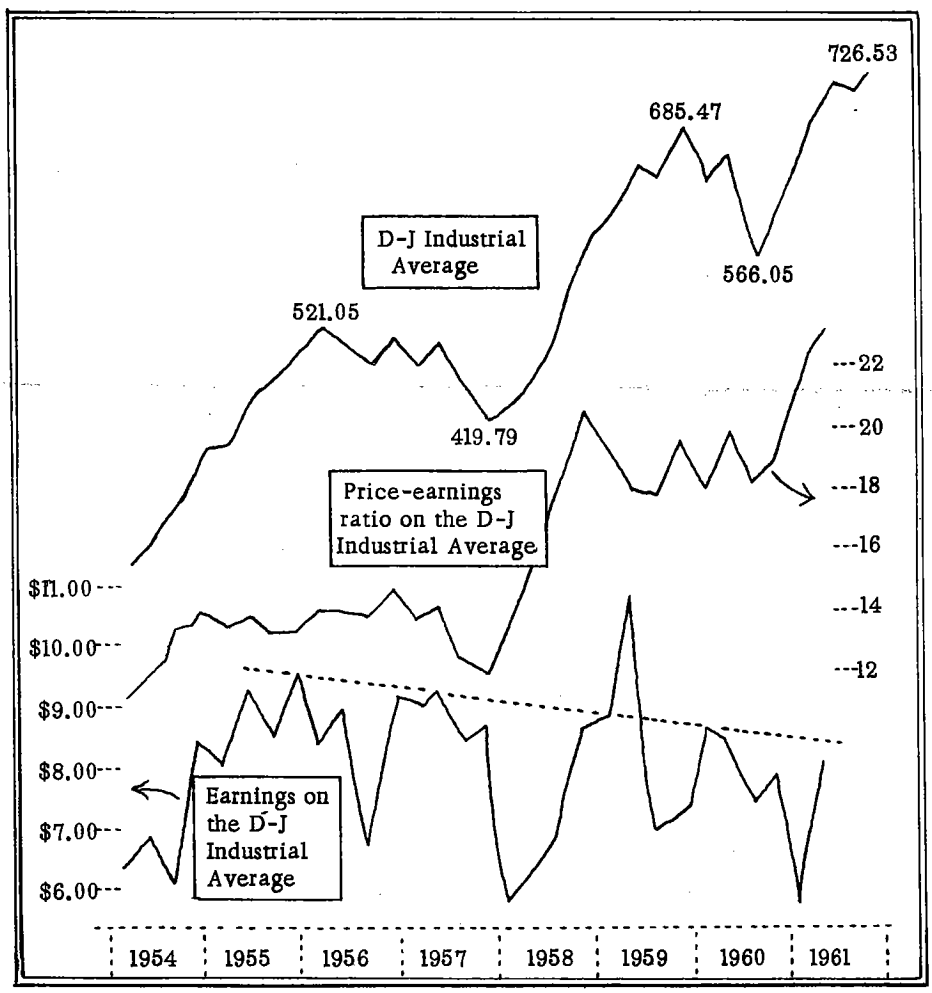
MORE ON VALUES 1955-57 represented the peak earning years on the Industrial Average for the period 1949 to 1961. Over those three years the D-J Industrial Average earned $35.78, $33.34 and $36.08 respectively (even though 1957 ended as a recession year). During the 1955-57 period of record earnings, investors were willing to pay from 12.1 to a maximum of 15.1 times earnings for the D-J Industrial Average.

As seen on the chart, the earnings on the Industrial Average (excepting the second pre-steel strike quarter of 1959) have been in a rather marked downtrend (dotted line) ever since 1955. Despite this, the Industrial Average, at its September, 1961, all-time high of 726.53, had risen 39% above the 1956 high of 521.05 (one of the peak earnings years).

What can we conclude from all this? Firstly, during periods of great optimism, the concept of "values" is ignored (in deference to "inflationary fears", speculative fever and sheer bullishness), and stocks may go up for no other reason than that people are willing to pay more for earnings. This phenomenon is clearly shown by the price-earings ratio line on the chart.

During the second quarter of 1961 the price-earnings ratio on the D-J Industrial Average rose to a record high of 23.5. While it is true that during the first and second quarters of 1961 the nation was coming out of a recession (and earnings had been impaired), the 23.5 P/E ratio of 1961 is still a far cry from the 12 and 13 P/E ratios of late 1957 and early 1958 (when the country was also coming out of a recession).

During the year 1929 the maximum P/E ratio recorded was 19.12. At the 1937 bull market top the highest P/E ratio reached was 12.96. The 1946 bull market top provided a peak P/E ratio of 11.56. It is therefore obvious that (1) we will need a forthcoming explosion in earnings to justify the current 23.5 P/E ratio on the Industrial Average, (2) even with a possible earnings explosion, the P/E ratios of 1961 are almost sure to represent the



 greatest over valuation in stock market history. Readers should remember (as with yields--see Letter 155) that this does not necessarily mean the end of the bull market today or tomorrow. A quarter of a century ago Robert Rhea was asked the question: "When is a bull market too high?" He answered it with another question: "How hot is hot?" By all past standards, we know that we are in an area of tremendously inflated values. This alone implies a certain amount of danger, yet timing the exact top of a bull move is impossible. For this reason I have emphasized that we are in "a trader's market" (not to be confused with "an investor's market", during which large positions in stocks may be held with confidence).

STOCKS Ten of the seventeen stocks in our "continuing study" group are above their long-term or 30 week moving average (a one-stock improvement over the last reading). The ability of a stock to remain above its long-term average price is, of course, a bullish omen. This is particularly true if that stock's long-term average is also moving higher.

The chart of Alcoa, the big aluminum producer, traces out what might be called "a trader's nightmare." AA broke its moving average (M. A.) in January of this year--then fluctuated between the 69-70 area for eight months. Last week AA broke below its M. A. (now 74 3/4) for its sixth test of the 69 area. Traders might buy it around 69-70 on the hopes that it will rally to 79 or better again (sell on a breaking of the 68 level).

Eastman Kodak has been a poor performer all year. It turned bullish in March, then broke below its M. A. (now 109) in June and has looked weak ever since.

General Electric is now one of the stronger looking stocks in the Average. It consolidated around the 60 level from February through July and has recently moved into high ground for the year (M. A. currently at 66 1/8).

Goodyear has been outperforming the market all year, and was repeatedly recommended (with G. E.) in earlier Letters. You're on your own with GT now (M. A. 40 7/8).

New York Central, "the tired old man" of the railroad industry, is again flirting with its low range. It touched 14 3/4 in December, 1960, 15 5/8 in July and 16 3/8 on its most recent decline. Central in the 15 5/8 to 16 1/2 area is a fairly limited risk, but probably a great deal of patience will be needed. (M. A. 18 1/2)

GOLD My friend Iain Fraser of 159 Bay St., Toronto 1, Canada, keeps me posted on the Canadian market. Of particular interest at this time is the great "saucer bottom" which has formed in the Canadian gold average (see chart). The bottom seems to have been completed in July, and since then the gold average has been rising towards the January, 1961 high. This could mean that a substantial move is forthcoming in the gold stocks (it also could mean that the "gold problem" and the adverse balance of payments situation is starting again). My favorite golds at this time are Campbell Red Lake and Bralorne.

LATE NOTE: American Telephone (see Letter 152) has finally broken below its M. A. (currently 121), after holding above its M. A. for ten consecutive months. We will probably see a test of the June 1961 low of 114 1/2. A break below that figure would mean that Telephone had definitely turned bearish.

Written Monday, September 18, 10 A.M.